APPENDIX.

Revenue Act of 1936, c. 690, 49 Stat. 1648.

Sec. 22—Gross Income.

(a) General Definition.—"Gross income" includes gains, profits and income derived from * * * businesses, commerce, * * *.

(c) Inventories.—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Sec. 23.—Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

(f) Losses by Corporations.—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

Sec. 41.—General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the

method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

Sec. 43.—Period for which Deductions and Credits Taken.

The deductions and credits * * * provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

TREASURY REGULATIONS 94 (1936 Ed.).

Art. 22 (a) (5). Gross Income from Business.—In the case of a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold * * *.

Art. 22 (c) (1). Need of Inventories.—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory merchandise

purchased, title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected.

Art. 22 (c) (2). Valuation of Inventories.—Section 22 (c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

* * * * * * * *

The bases of valuation most commonly used by business concerns and which meet the requirements of section 22 (c) are (a) cost and (b) cost or market, whichever is lower. * * *

Art. 22 (c) (4). Inventories at Cost or Market, whichever is Lower.—Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—

(a) Of goods purchased and on hand, and

(b) Of basic elements of cost * * *.

Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

Art. 23 (a) (1). Business Expenses.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected

with or pertaining to the taxpayer's trade or business * * *. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income * * *. Among the items included in business expenses are * * * commissions * * *.

Art. 23 (f) (1). Losses by Corporations.—Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible except in so far as not prohibited or limited * * *.

Art. 41 (1). Computation of Net Income.—* * * The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income.

Art. 41 (2). Basis of Computation and Changes in Accounting Methods.—The true income, computed under the Act and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. * * *

Art. 41 (3). Methods of Accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. * * *

In the Supreme Court of the United States

October Term, 1942

No. 865

The Esmond Mills et al., petitioners

v.

Guy T. Helvering, Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE RESPONDENT

Although we believe the decision below to be correct, we do not oppose the granting of a writ of certiorari in this case.

The question presented is whether amounts paid by the petitioner, The Esmond Mills, to its subsidiary, The Smithfield Company, (1) to reimburse the subsidiary for losses incurred because of a decline in its inventory values, and (2) to enable the subsidiary to obtain cancellation of certain purchase contracts, were deductible in determining the net income of the petitioner for the calendar year 1937. Fundamentally the issue is whether a parent corporation is entitled, for in-

come-tax purposes, to disregard the separate corporate identity of its wholly owned subsidiary and to deduct losses of the subsidiary as its own losses or ordinary and necessary business expenses.

This Court has granted petitions for writs of certiorari in *Moline Properties, Inc.* v. *Helvering*, No. 660, and in *Interstate Transit Lines* v. *Helvering*, No. 552, which involve similar questions with respect to taxation of the income of separate entities operated under common ownership. We believe that there are substantial differences between the instant case and those in which certiorari has been granted. However, we do not oppose the granting of this petition, since the Court now has before it for decision the question of whether the corporate identity of wholly owned subsidiaries may be disregarded for income-tax purposes; but we suggest that the Court may wish to withhold action upon this petition until those cases are decided, so that this case may be disposed of in the light of the decisions therein.

Respectfully submitted.

Charles Fahy,
Solicitor General.

April 1943.

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